MADISON INVESTMENTS INSURANCE SOLUTIONS

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MARKETS CELEBRATE AS THE FED FINALLY BEGINS EASING MONETARY POLICY

When the Federal Reserve (Fed) began raising rates in March of 2022, the market's handwringing began over the level of Fed Funds and possible recessionary impact. We think many market participants missed the offsetting impact of the fiscal stimulus from record Federal government deficits, which has allowed for continued economic growth. Over the last two years, the inflation rate has declined and the tight labor market has eased, allowing the Fed to reverse its tight monetary policy gradually.

In the second quarter of 2024, GDP grew at an annual rate of 3.0%. For the third quarter, the Atlanta Fed's GDPNow model forecasts a GDP growth of 2.5%, a slight increase from a previous estimate of 2.0%. Strong consumer spending and business investment have contributed to GDP growth. This is reflected in the upward revision of future GDP estimates.

Recent data showed a trend where headline CPI (Consumer Price Index) decreased to 2.5% in August 2024, down from 3.7% in August 2023, suggesting a cooling in inflation rates. This is also supported by expectations of core PCE inflation remaining in the range of 2.5% to 2.9% for 2024.

The unemployment rate for 2024 will most likely be in the range of 3.7% to 4.2%, which indicates a relatively stable employment situation with low unemployment levels.

We are also seeing a general trend of corporate profits being revised upward and strong business investment contributing to growth, which indirectly supports the economic health narrative for the period.

The Fed maintained the federal funds rate within the range of 5.25% to 5.50% throughout much of the third quarter. At its September meeting, the Fed cut the rate by 50 basis points (bps), citing sustainable declines in inflation and a loosing of demand in the labor markets. Investors foresee the Fed's policy rate by year-end 2025 to be about 50 bps lower than Fed projections (e.g. 2.9% vs 3.4%). Barring a large rise in unemployment or substantial economic slowdown, rates expectations are apt to readjust upward.

The anticipation of future rate cuts, along with the Fed's actions to maintain current rates, painted a picture of an economy in transition. While inflation was being managed down, the economic growth outlook was revised upwards, suggesting confidence in a soft landing scenario. The Fed emphasized a data-dependent approach, where incoming economic data would heavily influence future rate decisions. This strategy seems to have kept markets in a state of cautious optimism, with investors and analysts continuously adjusting expectations based on each piece of new economic data or Fed statement.

The Treasury yield curve regained a positive slope in September as the 10-year yield fell 0.62% to 3.78% and the 2-year yield fell by 1.11% to 3.64%. Interest rate probabilities indicate investors believe the Fed will cut rates another 200 bps by year-end 2025.

While overall credit health was considered stable, concerns about the vulnerability of lower-quality segments, indicating a preference towards high-quality, investment-grade securities for risk mitigation. Investment grade corporate bond spreads contracted 4 bps during the quarter to an average spread of 82 bps. For the year, corporate spreads are tighter by 10 bps.

The Bloomberg Intermediate Government/Credit Index returned 4.7% for the quarter and 4.68% YTD. However, the broader sentiment suggests a cautious yet optimistic outlook for investment-grade bonds, with yields remaining attractive but with a focus on quality due to concerns about economic slowdowns and potential policy shifts.

Agency mortgage-backed securities performed well in the quarter as spreads contracted along with declining yields. Although reinvestment rates have dropped about 100 basis points over the quarter, the steeping yield curve still provides opportunities for increasing portfolio book yields with reinvestment rates still significantly above most yields of maturing bonds.

In general, we would characterize the investment grade fixed income market as cautiously optimistic. Investors continue to favor agency mortgage-backed securities, high-quality, investment-grade bonds, and taxable municipal bonds for their stability and yield, amidst a backdrop of economic stabilization efforts and market adjustments to future monetary policy expectations.

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In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Bond Spread is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

Yield Curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward sloping curve), inverted (downward sloping curve) and flat. Yield curve strategies involve positioning a portfolio to capitalize on expected changes.

A basis point is one hundredth of a percent.

Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. Duration measures how long it takes, in years, for an investor to be repaid the bond's price by the bond's total cash flows.

High yield bonds are considered lower-quality instruments known as "junk bonds". Such bonds entail greater risks than those found in higher-rated securities.

The federal funds rate is the target interest rate range set by the Federal Open Market Committee (FOMC) for banks to lend or borrow excess reserves overnight. It influences monetary and financial conditions, short-term interest rates, and the stock market.

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

Bloomberg U.S. Intermediate Government/Credit Bond Index measures the performance of United States dollar-denominated United States Treasuries, government-related and investment-grade United States corporate securities that have a remaining maturity of greater than or equal to one year and less than 10 years.

Upon request, Madison may furnish to the client or institution a list of all security recommendations made within the past year.

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